The Natural Gas Roundtable of Washington

"FERC's RTO Policy and Its Impact on the Gas Industry"

Remarks by
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I. Introduction

Good afternoon. It is my honor to address this distinguished gathering of the Natural Gas Roundtable. As my grandmother used to say, "busy hands are happy hands." If this is true, we at the FERC have had very happy hands over the past few months. I am pleased that the Commission has moved aggressively in pursuing our initiative promoting the formation of regional transmission organizations (RTOs). We issued Order No. 2000 in December, and less than three weeks ago finalized our order on rehearing, Order No. 2000A. The Commission has also been busy on the gas side, recently issuing Order No. 637, our final rule on short-term natural gas transportation services.

I would like to discuss both of these initiatives with you this afternoon, and the interplay between them. I will also discuss FERC policy to facilitate interconnection to the electric grid by new generators.

Three years ago, the FERC held a 2-day public conference on the future of the natural gas industry. All the gas policy issues we heard testimony on were highly contentious among various gas industry segments. But above all the rancor and disagreement, the one argument that united all of the participants was that the Commission should pursue an aggressive electricity restructuring program. All witnesses instinctively understood the importance to the gas industry of competitive electric markets.

II. The Need for RTOs

So, it is appropriate that I begin with a discussion of the Commission's most recent pro-market electric policy, our RTO initiative. For several reasons, it is my firm belief that grid regionalization through the formation of RTOs in all regions of the Nation is absolutely critical, not only to electric markets but also to natural gas markets.

First, RTOs will break down the artificial boundaries that now confine markets. Artificial limitations on the geographic scope of electric markets raise prices. Grid regionalization will eliminate the existing balkanization of the grid that artificially restricts the size of the electricity trading market.

Second, RTOs will ensure that the grid is operated efficiently and in a non-discriminatory manner. Because of the physics of the power delivery systems, grid operators must have the appropriate scope needed for efficient management, and they must operate independently of merchant participants to ensure access decisions are made without favoritism or self dealing. RTOs will address these issues.

Third, RTOs will facilitate improved pricing for electric grid services. Because the nature of electricity transmission is regional in nature, it naturally follows that the pricing regime should be regional in scope.

Fourth, RTOs will help get new electric transmission facilities built. Under Order 2000, an RTO must be responsible for planning and arranging transmission expansions, and the RTO must coordinate such efforts with the appropriate state authorities. It is my hope that this will allow the various state authorities involved in siting approval to place value on a regional solution, find common ground, and approve facilities that are needed for regional commerce. In addition, the market based congestion management techniques the RTO will implement will send accurate price signals about the true cost of congestion. This will spur transmission capacity investment.

Fifth, RTOs will attract new generation participants. In a recent article in Public Utilities Fortnightly, its associate editor, Carl Levesque, observed the following:

> Standardization of power markets and transmission across a region, through formation of an independent system operator (ISO) and (in some cases) a spot market power exchange, provides a strong drawing card for new investment in generation.

You can substitute RTO for ISO in this quote, and the very perceptive point is the same. I will return to this issue of new generation entry several times during my presentation because it is a topic that is vital to both the gas and electric industries.

And sixth, by eliminating the current scheme of scattered and balkanized grid management, by regional planning for loop flow, by dealing with the seams among grid management regions, by improved regional congestion management, and by facilitating necessary grid expansions, the RTO will provide a more powerful and effective regional tool for reliable grid management. The reliability boost from RTOs is an unsung RTO benefit that perhaps electrical engineers understand the best. I intend to emphasize it more frequently.

III. RTO Formation

Given their significant benefits, the task before the industry is to get RTOs formed. It is a source of some frustration to me that the Commission chose a program that professes to be voluntary. The very real problems Order No. 2000 identified, demand real solutions now. I would have preferred a more direct way for FERC to get RTOs formed.

Nevertheless, the tone of Order No. 2000 could not be clearer. We expect a good RTO to form in every region of the country. We provide some enticing "carrots" in the form of rate treatments for RTOs that do form, and lay out some "sticks" – such as conditioning mergers and market-based-rates upon RTO formation – for utilities that don't form RTOs. The Commission has seen the future, and it will be defined by RTOs. So, I remain cautiously optimistic that the Commission's commitment to the regional collaborative process underway now, as a way to "jawbone" the formation of these institutions, will bear fruit.

At the same time, I share the frustrations of those who are concerned that the regional collaborative process – which represents the 3rd round of FERC-sponsored

regional conferences on this issue over the past two years – is just more talk. Market participants want action. This is, however, for better or worse, the RTO formation process the Commission has chosen, and I urge all market participants to attend a regional conference and express your views.

IV. Impact of RTOs on the Natural Gas Industry

Now let me shift gears somewhat. Let's assume that RTOs that meet Commission standards with respect to independence and regional efficiency do in fact form. What will be the impact of this pro-competitive electric policy on the natural gas industry?

Clearly, making the electric grid function more efficiently and reliably will spur new gas-fired electric generation. Most of the studies I have read certainly predict major increases in gas use by the year 2010 or 2015 – at least a 30 Tcf gas market, and some have predicted a 35 Tcf market by 2020.

Much of the projected increase in gas use will come from the electric generation sector, with demand expected to grow 4.5 Tcf by 2015. It appears that virtually all new generation in the U.S. will be gas fired. Many of these new facilities will be merchant plants built to sell into the market. Clearly, merchant generators crave the vibrant electric markets RTOs will facilitate. New generators will insist that the grid be operated without favoritism. The elimination of pancaked transmission rates will allow them to sell their power to a much larger market. They will be attracted to the one-stop-shopping provided by a single grid operator. A more reliable high voltage grid operation will give generation investors greater confidence when siting their facilities. RTOs will provide all of these benefits.

The development of RTOs will also encourage entrepreneurs to site new gas-fired generation in areas that now suffer from transmission bottlenecks. By easing these bottlenecks, new generators will serve a valuable congestion mitigation and management function on the electric transmission grid.

Obviously, the pipeline infrastructure will have to meet the challenge of the increased demand for natural gas-fired electric generation, so another impact of RTO development will be an increase in pipeline construction. We are, of course, already seeing this in many regions of the country. In carrying out our pipeline

certification responsibilities, the Commission is engaged in a delicate, but critically important balancing act requiring a weighing of all competing concerns. We must ensure that every foot of needed pipeline capacity is certificated, but we must do so in a manner that appropriately respects landowner and environmental concerns. This is a challenging responsibility.

In addition, pipelines must develop tariff provisions that take into account the unique requirements of electric generators, which may vary hour by hour. Over the past year, Reliant, Panhandle and ANR have done just that by designing an hourly firm transportation service to meet the need of electric generators for greater flexibility. RTOs will provide additional incentives for other pipelines to follow suit.

New generators spurred by RTOs will also serve a valuable function in facilitating efficient pipeline operation and increasing overall pipeline load factors. Traditionally, most natural gas pipelines have experienced their strongest demand during the winter heating season. However, new gas-fired electric generation will result in higher load factors for pipelines during the summer. The load-leveling effect of electric generation will complement the short-term seasonal rate programs that are envisioned by the Commission's short-term gas rule, Order 637, which I will turn to momentarily.

Finally, RTOs reinforce the wisdom of the transactional transparency that will result from the enhanced reporting requirements for pipelines under Order No. 637. The real-time transaction reporting requirements for pipelines apply to all capacity transactions, and will make it easier for pipeline customers to determine how much capacity is available, where, and at what price. This will be vitally important to the new gas-fired generation that RTOs will attract.

V. Order No. 637

Now, let me turn my attention squarely to Order No. 637. I've already touched briefly on a few of its provisions. The Commission initiated this rulemaking to build on the huge success of Order 636. Most significantly, the rule removes the price cap on short-term capacity releases until September 30, 2002. I struggled with this feature of the rule out of concern about the potential for large

holders of capacity to exercise market power and drive up the price. The proposed rule would have required capacity to be sold through an auction, and I viewed this mechanism as an important market power mitigation measure. But commenters torpedoed the auction proposal. I must say, however, that cyberspace afficionados are thoroughly convinced that the online auction will in the near future become an ubiquitous presence in the world of E-commerce for many industries, and will revolutionize the way in which all sorts of goods and services are sold. The auction gives power to the customer. Nevertheless, in the final rule, the auction was relegated to a voluntary mechanism.

This leaves only one real measure in the rule that I regard as having potential to mitigate market power in the release market: that is the enhanced transactional reporting requirements I described earlier. The real time data generated by these requirements will allow the Commission and industry to monitor for market power abuse. Lifting the price caps is, thus, a program that will be evaluated carefully on an ongoing basis, using the transactional information required by the rule.

I have also alluded to seasonal rates, which I believe will provide valuable flexibility to pipelines and their customers. Seasonal rates have the potential to make pipeline utilization more efficient. They provide economic incentives to maximize throughput during both peak and off-peak periods with rates that more truly reflect the value of the capacity.

The operational changes the rule will require are sometimes overshadowed by the sexier price cap and seasonal rate provisions. I believe, however, that the operational requirements offer great promise in improving the efficiency of the natural gas delivery system. The rule requires comparability between released capacity and primary capacity by requiring that pipelines afford the same nomination flexibility for released capacity that is available for primary capacity. Customers will have greater flexibility in using and releasing their capacity, because the rule allows shippers to segment to the extent operationally feasible. Through the pipeline balancing procedures required in the rule, shippers' ability to avoid imbalance penalties will be greatly facilitated. Among the examples of balancing options that might be offered by pipelines under this requirement are parking and lending service, allowing shippers to swing on pipeline system storage, and imbalance netting and trading.

The Commission declined to authorize pipelines to negotiate terms and conditions of service. I had strong reservations about this proposal and am pleased that the rule maintains current policy on this issue. I am convinced that the Commission's existing tariff procedures are sufficiently flexible to allow pipelines to develop innovative services tailored to specific customers' needs. I would cite the Reliant, Panhandle and ANR hourly tariffs services as examples.

The Commission concluded that negotiated terms and conditions of service is one of several issues that warrants more deliberations. The rule identifies several other issues for continued dialogue, including the increasing convergence of energy markets, the need for greater standardization of terms and conditions of service across the grid, whether the Commission's policy on pipeline affiliates warrants further revision, and whether the Commission should fundamentally reform its current regulatory model for pipeline ratemaking such as through performance based mechanisms. I expect these issues to be thoroughly vetted in our continuing dialogues.

VI. Electric Grid Interconnection Policy

Before I close, I want to raise a related issue that is vital to both the gas and electric industries. In order to serve the market, the new generating resources I have discussed earlier must get interconnected to the electric grid. But marketers and generators have described barriers to interconnection, in the form of a protracted, gamed process for securing an interconnection, or a requirement that generators purchase long term transmission service in order to secure interconnection. Generators and some utilities tell us that negotiating individual interconnection agreements is time consuming, burdensome and should be unnecessary. At least two transmission owners, Entergy and Commonwealth Edison, have recently petitioned the Commission to approve uniform interconnection agreements for their regions.

I am pleased to report that, just yesterday, in a case styled Tennessee Power, the Commission clarified interconnection policy in three positive ways. First, the Commission declared that interconnection is an element of transmission service required to be provided under our pro forma tariff and that generators have the right to request the interconnection component separately from the delivery component. Our policy now recognizes that merchant plants may not have long term sales

contracts and thus may not at the outset need long term transmission service. Generators now know that the transmission provider can no longer demand that they purchase long-term delivery service in order to get interconnected. In other words, we unbundled "access to the grid" from "access across the grid."

Second, the Commission declared that, once secured, the interconnection component of transmission service conveys a right to inject power into the grid at the point of interconnection, consistent with the parameters of the service agreement. This means that a generator that has secured interconnection cannot be later denied delivery service on the ground that the network facilities at the interconnection point cannot handle the power. In other words the generator will not suddenly find itself "stranded from the grid."

And third, the Commission clarified that when a generator requests the interconnection component of transmission service, the protections afforded by the pro forma tariff provisions apply to interconnection. These include procedures for arranging service, time limits, customer responsibilities, study procedures, compensation for new facilities, and service agreements. These protections should go a long way toward resolving many of the problems of securing interconnections we've heard from generators and the need for a defined process with time lines and safeguards. These reasonable and time-limited procedures will eliminate interconnection legerdemain.

And perhaps most important is that the transmission provider must file for Commission review an unexecuted interconnection service agreement within 30 days after the transmission customer requests it. Thus, an interconnection customer can stop any delay and get a timely decision from the Commission on interconnection. This is an important protection.

These policy pronouncements are excellent ones that will facilitate interconnection. The Commission's policy will allow independent generators to interconnect on terms similar to those enjoyed by utility generation. But I would urge the industry and the Commission to take an additional step. I urge each transmission provider to develop a fair and reasonable standard agreement that sets out the steps and technical standards required for securing an interconnection. Standardizing interconnection agreements will streamline and cut down "negotiating time" to the benefit of both transmission provider and generator.

Moreover, I would urge the industry and the Commission to move aggressively toward an industry-wide standard interconnection agreement. Our pro forma transmission tariff under Order No. 888 standardized transmission service across market areas. It strikes me as logical that a "pro forma interconnection agreement" would be equally beneficial. I would also note that the recent report by DOE's Power Outage Study Team finds a need to remove barriers to the use of distributed generation resources to ensure reliability during peak demand times, and that interconnection standards for these generation resources should be developed. Standard interconnection agreements is an area where a uniform national model can provide huge pro-market benefits. I urge its consideration.

VII. Conclusion

Let me conclude by saying that the Commission has been unusually productive in facilitating vibrant markets for both natural gas and electricity. We have good programs in place, and our electric generation interconnection policy is evolving well. There is clearly a synergy here, with pro-market electric policies benefitting natural gas, and vice-versa. Our policies promoting efficient and nondiscriminatory services by energy transporters over a well functioning network of pipelines and wires are motivated by pro-market goals, and will in turn benefit consumers.

Thank you.